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No. 82-426

In the Supreme Court of the United States

OCTOBER TERM, 1982

ROBERT M. SNELL AND ROSALIE J. SNELL, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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In this federal income tax case, petitioner[1] seeks review of the decision which denied his claim for a refund of taxes based on his attempt to deduct losses incurred by his partnership prior to his entry into that partnership.

The pertinent facts may be summarized as follows (Pet. App. 2, 10): On December 29,1975, petitioner acquired a 49% interest in what had been a three-member Nebraska partnership, in exchange for a contribution of $375,000, thereby reducing the interest of each of the original partners from 33-1/3% to 17%. The partnership agreement, as amended, accorded petitioner, *inter alia*, 90% of partnership profits or losses for its taxable year ending December 31, 1975. On its federal income tax return for 1975, the

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[1]Rosalie J. Snell is a party solely by virtue of having filed joint tax returns with her husband. References to "petitioner" are to Robert M. Snell.

partnership reported a loss of $442,408. On his federal income tax return for 1975, petitioner claimed 90% of this loss, *i.e.*, $398,168, as his distributive share. The Internal Revenue Service determined, on the basis of various adjustments, that the partnership's net operating loss was $337,232, rather than $442,408. The Internal Revenue Service also determined that petitioner was entitled to report only 49% of the partnership's loss, rather than 90%, and that the loss properly reportable on his 1975 return was $165,244 (49% of $337,232), rather than $398,168 (90% of $442,408).[2] These adjustments resulted in a deficiency of $82,261.65. Petitioner paid the deficiency and brought his refund suit in the United States District Court for the District of Nebraska. The district court held (Pet. App. 9-17) that petitioner could not recover these amounts because he was not entitled to claim a deduction for partnership losses which were sustained prior to his entry into the partnership, and the court of appeals affirmed (Pet. App. 1-8).

1. The decision below correctly denied petitioner's claim to partnership losses incurred prior to his entry into the partnership. Petitioner joined a partnership in 1975 near the close of its taxable year. He contributed $375,000, and then

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[2]Petitioner was, in fact, only entitled to either 90% of 3/365 of the 1975 partnership loss (based on the number of days of the year he was a partner), or 90% of the actual losses incurred during his membership in 1975, *i.e.*, December 29, 1975, through December 31, 1975. Hence, petitioner should have been allowed only $2,494.59 in 1975 partnership deductions (90% of 3/365 of the $337,232 allowed after audit). The Internal Revenue Service erred in allowing taxpayer far more than that to which he was properly entitled, but the statute of limitations barred any government counterclaim for further deficiencies to correct this error. The government, however, was free to defend the case on the proper ground, and to retain any monies already received. This did not amount to an untimely assertion of additional deficiencies. *Lewis* v. *Reynolds*, 284 U.S. 281, 283 (1932).

claimed a $398,168 deduction, representing his putative share of partnership losses which had accrued prior to his entry into the partnership. This deduction was barred both by the provisions of Subchapter K of the Internal Revenue Code of 1954 (26 U.S.C.), relating to partners and partnerships (Sections 701 *et seq.*), and by the assignment of income doctrine.

An individual partner can reduce his interest in the partnership during a taxable year, due to a sale, exchange, or entry of other partners. Where such a reduction in interest takes place, Section 706(c)(2)(B) of the Code requires that individual partner to take into account this reduction when determining his share of subsequent profits or losses sustained by the partnership.[3] Conversely, a new partner cannot share in profits or losses sustained by the partnership prior to his entry. The decision below so held (Pet. App. 5-6) in accord with a uniform line of authority. See, *e.g.*, *Williams* v. *United States*, 680 F.2d 382 (5th Cir.1982); *Rodman* v. *Commissioner*, 542 F.2d 845 (2d Cir.1976); *Moore* v. *Commissioner*, 70 T.C. 1024 (1978); *Marriott* v. *Commissioner*, 73 T.C. 1129 (1980); *Richardson* v. *Commissioner*, 76 T.C. 512 (1981), appeal pending, No. 81-4387 (5th Cir.).

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[3]Act of Aug. 16, 1954, ch. 736, Section 706, 68A Stat. 242-243 read, in pertinent part, for the taxable year ended December 31, 1975, as follows:

Section 706. Taxable years of partner and partnership.

* * * * *

(c) Closing of partnership year.

(1) General rule.

Except in the case of a termination of a partnership and except as provided in paragraph (2) of this subsection, the taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's interest in

Petitioner argues (Pet. 14-16) that the term "reduced" in Section 706(c)(2)(B) does not refer to a reduction in interest occasioned by the entry of a new partner. As the court of appeals noted, however, the term "entry of a new partner" is included in Section 706(c)(1) (Pet. App. 6).[4] Nor is there merit to his claim that his capital contribution enhanced the value of the partnership, and hence the value of the other partners' interests (Pet. App. 5). The Code refers to a reduction in interest, and not to value. For pre-existing partners, the Code requires them to take into account their increase or reduction in interest when computing their share of

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the partnership, or the sale or exchange of a partner's interest in the partnership.

(2) Partner who retires or sells interest in partnership.

* * * * *

(B) Disposition of less than entire interest.

The taxable year of a partnership shall not close (other than at the end of a partnership's taxable year as determined under subsection (b)(1)) with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to a partner whose interest is reduced, but such partner's distributive share of items described in section 702(a) shall be determined by taking into account his varying interests in the partnership during the taxable year.

[4]Sections 704 and 706 were amended by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, to make clear that allocations of pre-entry accrued gains and losses to incoming partners were barred, and that Section 706 applied to partners whose interests were reduced, as here, by the admission of a new partner. S. Rep. No. 94-938, 94th Cong., 2d Sess. 94-98 (1976). These amendments, however, merely clarified and codified prior law. *Williams* v. *United States*, *supra*, 680 F. 2d at 385-386; 1 A. Willis, *Partnership Taxation* § 24.05 (2d ed. Supp. 1981).

post-entry profit or loss. Likewise, petitioner cannot share in pre-entry profit or loss incurred at a time when his interest in the partnership was zero.[5]

Nor can petitioner claim (Pet. 11-13) that Section 706 is subordinate to Section 704, which permits partners to allocate profit or loss according to the partnership agreement.[6] Section 706(c)(2)(B) is in no way inconsistent with Section 704, and Section 706(c)(2)(B) requires that varying interests be taken into account whenever a reduction in interest occurs, as the court of appeals held (Pet. App. 6). Furthermore, Section 704(b)(2) strikes down partnership agreements which allocate profit or loss to evade taxes, and an allocation of pre-entry profit or loss to an incoming partner is a per se violation of Section 704(b). *Rodman* v. *Commissioner, supra*, 542 F.2d at 857-858.

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[5]Petitioner also argues (Pet. 11-13) that Section 706 does not encompass bottom-line profit or loss, but rather only specific items of income or deduction. Section 706(c)(2)(B), however, refers to all the items enumerated in Section 702(a), which latter section includes bottom-line profit or loss.

[6]Act of Aug. 16, 1954, ch. 736, Section 704, 68A Stat. 240-241 read, in pertinent part, for the taxable year ended December 31, 1975, as follows:

Section 704. Partner's distributive share.

(a) Effect of partnership agreement.

A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

(b) Distributive share determined by income or loss ratio.

A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9), for the taxable year, if—

(1) the partnership agreement does not provide as to the partner's distributive share of such item, or

(2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive

2. The court of appeals also correctly held (Pet. App. 7) that the assignment of income doctrine barred petitioner's claim. That doctrine, described by this Court as the cornerstone of our system of taxation, is that income (or loss) is ascribable only to him who earns (or sustains) it. It cannot be assigned to others, which is precisely what petitioner seeks. *United States* v. *Basye*, 410 U.S. 441, 450 (1973).

Petitioner argues (Pet. 20-24) that this principle is inapplicable to partnerships. He cites Sections 704 and 761 of the Code, which allow current partners some flexibility in making end-of-year adjustments to their partnership agreement and hence in changing the amount of profit or loss reported by individual partners. But petitioner was not a member of the partnership when the losses he claims as deductions were sustained. Sections 704 and 761 therefore have no application.

Petitioner, citing *United States* v. *Basye, supra*, advances the novel contention (Pet. 22) that a partnership is a separate entity which earns income or sustains loss, and then pays it out. But *Basye* completely refutes petitioner's argument. It holds that a partnership is only a conduit of profit or loss and that individual partners are currently taxable on partnership income, even though actual distribution might occur years later, when they no longer

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share of such item is the avoidance or evasion of any tax imposed by this subtitle.

* * * * *

(d) Limitation on allowance of losses.

A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership. * * *

belonged and would not share in it. The loss sought to be deducted by petitioner belongs to those who were members of the partnership when it was sustained. Such a loss is not held in abeyance by the partnership to be later bestowed upon others.[7]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

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[7]Petitioner also contends (Pet. 18-20) that the courts below construed facts against him contrary to the standard governing summary judgment disposition. The court of appeals was fully aware of the correct standard (Pet. App. 3-4), and needed to infer no facts adversely to petitioner to decide the legal issue presented.

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